Thus, whatever may be said of the current competitiveness of the long distance market, Sprint, like AT&T, has in effect conceded that until 1996 or 1997 prices were not consistent with the kind of intense competition that they claim prevails at the present time. Moreover, Ms. Banks concedes that most subscribers paying the basic rate (i.e., small users), which she says are disproportionately served by AT&T, have not benefited from Sprint's asserted because it tends not to serve them.

29. The price data offered by the witnesses for AT&T and Sprint therefore confirm our conclusion that small users did not, in the prices they actually paid, receive the full benefit of the reductions in the access charges that their service providers were forced to pay the local telephone companies, let alone from any compression in those providers' margins above costs. AT&T's promise to the Consumer Federation of America and the FCC in the spring of 1997 that it would pass through to small residential customers promised reductions in access charges—and the implied promise of the Commission to monitor its compliance—was itself in effect a concession to the previous complaints both of these parties expressed before that time about the sufficiency of competitive pressures alone. And of course a promised rate reduction equal only to a further reduction in access charges would do nothing to reverse the large price increase net of those charges in the preceding five years.

B. The Benefits of Southwestern Bell's Entry into the InterLATA Market

30. The FCC, having previously expressed "serious concern" about the apparent pattern of price leadership that had emerged in the long-distance business,[30] has recognized that

[30] Order, In the Matter of Motion of AT&T to be Reclassified as a Non-Dominant Carrier, Federal Communications Commission, FCC 95-427, Adopted: October 12, 1995; Released: October 23, 1995, par. 81-83.

"the Act provides the best solution to any problem of tacit price coordination...by allowing for competitive entry in the interstate interexchange market by the facilities-based BOCs...."[31] Southwestern Bell's entry will promote effective competition by reducing the ability of the IXCs to engage in such quasi-collusive pricing at the expense of small residential customers.[32] It will have this effect not merely because it will increase the number of large, well-positioned competitors in its region by one; more important, it will introduce a large competitor that (a) begins with a zero market share, (b) is, by virtue of the likely large volume of its purchases, in a particularly strong position to take advantage of the large excess transport capacity of the present market-dominating IXCs[33] and (c) has cost characteristics and (d) a current mix of services uniquely promising to remedy the single greatest deficiency in the performance of the long-distance market.

31. While they would be a powerful market presence within their respective LATAs from the outset, the RBOCs would begin interLATA competition with a zero market share—much like the competitive position of the interexchange carriers when they were permitted to offer service within the LATAs; they would have to offer attractive prices to break into that market.

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[31] Notice of Proposed Rulemaking, In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace Implementation of Section 254(g) of the Communications Act of 1934, as amended, CC Docket No. 96-61, Federal Communications Commission, 11 FCC Rcd 7141; 1996 FCC Lexis 1472, FCC 96-123, Adopted: March 21, 1996, Released: March 25, 1996, par. 81, footnote omitted.

[32] Our assertion is supported by the Affidavit of Professor Marius Schwartz, dated May 14, 1997, filed on behalf of the DOJ in response to Southwestern Bell's Oklahoma petition (CC Docket No. 97-121), in his discussion of the significant efficiency advantages a BOC would bring to the long distance market. He states specifically that "A BOC would be especially well placed to address lower-volume customers." (Schwartz, p. 33, par. 96) On Professor Schwartz's later contention that the potential benefits of competitive entry into local Telcom markets would be even larger, see par. 42, below.

[33] FCC 95-427, par. 57-62.

1. A more effective competitor

32. There are of course already hundreds of resellers of long distance service. Typically purchasing these services from a facilities-based carrier under long term contracts, such as AT&T's contract tariffs or Tariff 12 options, they have mainly targeted business customers with monthly long distance bills of several hundred dollars. While SBLD is considering deploying some facilities, it will probably first provide services on a resold basis, because the current capacity of the combined interLATA networks is sufficiently large to meet immediate needs. SBLD is well positioned to be highly effective in obtaining underlying services from IXCs and more effective than pure resellers in reaching small customers.

33. The present resellers have been disadvantaged by lack of a strong brand name. They have therefore had to rely heavily on direct personal approaches and negotiations, which are unlikely to be economical in soliciting the business of low-volume users. SWBT, in contrast, already serves those customers and has a strong established brand name.[34]

34. At the buying end, SBLD is likely to be able to negotiate much more favorable terms with the IXCs than the present resellers, because of the large volumes of purchases to which it is likely to be able to commit itself. (And of course volume discounts at favorable prices are a common phenomenon across the entire economy in such circumstances.) Within the last two years, SBC, NYNEX, Bell Atlantic, Ameritech, BellSouth and GTE have entered into agreements with such IXCs as AT&T, Sprint and LDDS WorldCom to resell their long-distance services, at prices in the 1-2 cents per minute range.[35] The addition of switched access charges

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[34] Ameritech Order, par. 15.

[35] "NYNEX To Resell Sprint Service," Bloomberg LLP, April 24, 1996. "Bells, GTE Lay Out Marketing Strategies, Swap Success Stories at New York Conference," *Telecommunications Reports*, September 26, 1996. C. McElroy, "BellSouth To Buy Time On AT&T's Long-Distance Network," Bloomberg LLP, June 19, 1996.

(by imputation at the originating end and by payment to other LECs at the terminating) of about 5-6 cents per conversation minute and any additional costs associated with customer service, marketing, billing and collections would evidently produce total LRICs below 10 cents per minute[36]—leaving wide room to under-price the IXCs. (Recall that AT&T's *average* revenue per minute was 17.3 cents in 1996.[37])

2. Economies of scope

35. We have already referred to AT&T's claim that its service to residential customers does not break even until their long-distance bills reach $3 a month, because there are fixed costs of serving each customer regardless of his or her volume of usage. The BOCs already incur many of those costs because they already serve most of those customers in-region: this means the *incremental* customer costs of adding long-distance to their present mix of services would be very small.

36. Another way of characterizing this positive case for removing the barriers to BOC provision of interLATA services is the fundamental proposition that they—like all other potential entrants—possess strong capabilities and potential comparative advantages in the interLATA markets and are therefore well-positioned to make important, welfare-enhancing contributions that they are currently prohibited from making. These advantages are an example of the economies of integration or of scope. They arise whenever conduct of two or more activities in a single firm is more economical than if they were conducted by separate firms—

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[36] See the various estimates summarized in note 10, above. Observe that the 6-7 cents per minute upper limit on non-access incremental costs that we cite (and question) there are as high as they are because they are estimates of the incremental cost of the entire long-distance service. The cost (particularly marketing and customer service cost) of a local telephone company *adding* long-distance service to its offerings would clearly be substantially lower than that.

[37] See note 8, above.

generally because of the presence of facilities, personnel or capabilities that can be shared by them. The achievement of these economies is frustrated when markets are balkanized and firms in one arbitrarily excluded from another—arbitrarily in the sense that the reasons have no grounding in technology or economics—as occurred when the MFJ excluded the RBOCs from the interLATA and the interexchange carriers from the intraLATA business. Except if they are prevented by statute or regulation from availing themselves of these opportunities, the cost to the BOCs of adding the provision of interLATA toll to a plant and organization already designed to provide only intraLATA services would be lower than the cost of setting up a separate entity to serve that market alone—because, obviously, they already possess a large portion of the capabilities of taking on those additional functions.[38]

37. These at present incompletely utilized talents or facilities represent opportunities for the firm as a potential supplier of those other common products or services. To minimize their total costs and to recover their fixed and common costs—particularly under the constraints of competition—telecommunications firms must constantly seek out and develop services or lines of business that generate economies of scope with their current service mixes.

38. Both the BOCs and IXCs are precluded from taking full advantage of those economies today—the former because they are prohibited from combining interLATA traffic with their current intraLATA offerings, the latter to the extent they are unable to add local exchange service to their long-distance offerings. That of course is why the Telecommunications Act requires the LECs to make those services available to other providers

[38] The Act's requirement that the RBOCs offer interLATA services via a separate entity during a transitional period would of course temporarily deprive them and the public of some of those benefits.

at wholesale and links the removal of the first handicap, symmetrically, to the removal of the other.

39. That a central purpose of the Telecommunications Act is to achieve a symmetrical lifting of restrictions on the exploitation of economies of scope by any and all participants in the market is manifest throughout its text. One particularly apt illustration is the provision that restricts large IXCs from jointly marketing their own interLATA services with local exchange services purchased from a BOC until the latter company is itself authorized to provide interLATA services in region or until 36 months from the date of its enactment.[39] This clear intention of the Act to free all competitors, symmetrically, to take advantage of their own particular economies of scope is further reflected in its explicit stipulation that the requirement on the BOCs to offer their interLATA services through a separate subsidiary be limited to three years from the date of authorization, unless extended by FCC rule or order. Clearly that requirement, which cannot but entail sacrifice of some of those economies in the case of the BOCs, should be removed at the earliest practicable date.[40]

40. BOC entry is almost certain to produce benefits besides driving and holding prices closer to present incremental costs. Competition is a dynamic process. It exerts powerful pressures on suppliers to improve productivity and to be innovative. The incumbent interexchange carriers may contend that competition is already sufficient for these purposes. Such an assertion cannot possibly be valid, especially when the prospect is one of entry by a new *type* of competitor—different in the mix of services it provides, the distinctive features of its

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[39] *Telecommunications Act of 1996*, Pub. L. No. 104-104, February 8, 1996, Sec. 271(e). The same time period applies to the separate subsidiary requirement on the BOCs under Sec. 272. Sec. 272 (f) (1).

[40] The FCC's implementation of the Act principally limits joint activities to the areas of sales and customer support.

technology and the depth of its customer base. Elimination of the barriers to this new and powerful source of competition will introduce new, additional stimuli to improving productivity and innovation as well as to genuine price competition for the patronage of residential and small business customers—a protection essential now that the FCC's approval of AT&T's petition to be classified as non-dominant has virtually eliminated previous regulatory restraints.

41. *In sum, the costs to consumers of a continued prohibition of the BOCs offering interLATA service are very large*: this proposition is, we submit, indisputable. What remains to be considered is whether the historical purpose of that restriction—to encourage the transformation of the long-distance business from monopoly to competition by eliminating any incentive on the part of the local telephone companies to use their monopoly power to exclude rivals from a fair opportunity to compete—continues to justify consumers continuing to bear those heavy costs. While we propose seriously to assess the dangers of the BOCs engaging in such exclusionary tactics, it need not bias that discussion if we point out at the outset that our preceding analysis has already definitively answered that question: there is not the slightest doubt that entry by the BOCs into the long-distance business will intensify competition. *The converse of that proposition—which we now proceed to expound—is similarly indisputable: there is not the slightest possibility that they could so expand the zero market share with which they begin, debilitate such competitors as AT&T, MCI and Sprint to such a point as to drive them from the market, and thereby restore the vertically integrated monopoly of local and long-distance service that it was the purpose of the consent settlement of 1982 to dissolve.*

42. In his Supplemental Affidavit in support of the recommendation of the Department of Justice that applications by RBOCs for lifting of the prohibition on their offering interLATA service be denied until they have more fully satisfied the burden of demonstrating their

cooperation in establishing the conditions for competition at the local level, Professor Schwartz contends that the potential benefits of that local competition greatly outweigh the incremental benefits of RBOC entry into the interLATA market, mainly, it appears, because the market for local services is much the larger of the two and local markets today are "rife with distortions." (p. 8)[41] What his argument almost totally ignores is the fact that those distortions—which we agree are enormous—are regulatorily imposed and are unlikely to be eliminated by competitive entry, so long as regulators persist in their present policies of geographically averaging and suppressing prices of basic residential service far below economically efficient levels, except if and as the ILECs are deprived of a reasonable opportunity to recover the costs of that cross-subsidization. Unless and until that occurs, local competition will consist, preponderantly, of cream-skimming, concentrating on the services whose prices have been and continue to be grossly inflated to finance that cross-subsidization.[42] There can be no assurance that such competition, artificially encouraged, is efficient. Any insistence on the enormous benefits to be achieved by more local competition that simply ignores these regulatory barriers and distortions, as Professor Schwartz essentially does, amounts in effect to writing *Hamlet* without mention of the Prince of Denmark.

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[41] Exhibit 2, dated November 3, 1997, Evaluation of the United States Department of Justice. In the Matter of Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in South Carolina, CC Docket No. 97-208, November 4, 1997.

[42] Contrary to Professor Schwartz's claim, it is not even clear that residential customers have enjoyed lower prices for the imperfectly competitive interLATA services than they have for the still regulated local services. After accounting for the regulatorily-imposed shift in costs from toll to local prices, represented by the $3.50 federal subscriber line charge, we calculate that local prices (adjusted for inflation) actually decreased more than did interstate toll prices—both of which we measure with their respective consumer price indices.

IV. THE RISKS OF ANTICOMPETITIVE CONDUCT AFTER ENTRY ARE SMALL AND OF SUCCESSFUL SUPPRESSION OF COMPETITION NIL

43. The contentions that the RBOCs should not be freed of the line-of-business restrictions on them because they may be expected, if freed, to engage in anticompetitive conduct have been preponderantly (a) hypothetical—reasoning from their asserted continuing monopoly power and incentives to engage in such conduct and (b) anecdotal—citing asserted instances of such conduct. The combination, however, of (1) the regimes already in existence under which the BOCs had been providing equal and non-discriminatory access to their facilities by the long-distance companies with which they now seek the opportunity to compete, even before passage of the Telecommunications Act of 1996 and (2) the comprehensive requirements of the Act itself and of the FCC's rules implementing its provisions makes the likelihood of discrimination against competitors remote and of any such discrimination effectively precluding their successful competition nil. This prediction is confirmed by the long history—typically ignored by opponents of the present petitions—of successful competition between the BOCs and competitors dependent on them for essential inputs. We proceed in this section to review these several considerations and that history.

A. Existing Safeguards Against Discrimination: audited service quality standards, monitoring by customer/competitors, penalties and opportunities for retaliation

44. The quality of interexchange access is closely monitored by both competitors and regulators. In order to discriminate successfully in the future, Southwestern Bell would not only have to explicitly violate the new Act; it would have to do so in such a way that the differences in quality *would be sufficiently detectable by customers to induce them to shift their patronage*

to it while going undetected by sophisticated competitors and regulators—an eventuality so unlikely as to border on the impossible.

45. Nor are those competitors dependent solely, for the redress of such discriminations as they do detect, on the protections of government authorities. On the contrary, in keeping with the central purpose of the competitive policies at the State and Federal levels, they already have the protection of being able to obtain from competitors direct access to a substantial percentage of their *total business* (although still only a minority of *subscribers*) of any offending BOCs.

1. The established regime for competition

46. SBLD's potential competitors are already operating in the interLATA market and dominate it. AT&T, MCI and Sprint are large and powerful competitors, certainly more formidable rivals than MCI and Sprint were to AT&T in 1984. Their nationwide optical fiber networks are in place; their costs are sunk; and their networks can be quickly turned to provide nearly any telecommunications service that appears to be profitable. In this world, competitive strategies involving predatory pricing (e.g., cross-subsidization or a vertical price squeeze) by a new entrant or an incumbent are doomed to fail. For a strategy that sacrifices profits (effectively investing in the destruction of a rival) to succeed, the would-be predator must be able actually to drive the targeted competitor from the market and, by so doing, be in a position to recoup its current losses at some future period. It cannot possibly succeed in this endeavor if the rival is a telecommunications network-based carrier, because there is no way of driving such a network out of the market; the costs associated with it are preponderantly sunk. Whenever the local carrier tired of earning less money in the interstate toll market than it could earn in the carrier

access market, it could raise its toll price, but it would find competitors still in place and ready to compete.[43]

47. Arguments about the danger or likelihood of vertical squeezes and transfer of inputs among affiliates at discriminatorily favorable prices completely ignore the statutory requirements of imputation and the sufficiency and efficacy of efficient component pricing rules in ensuring the ability of equally efficient competitors to survive and to prosper in competition with the ILECs. The FCC has just reached the same conclusion:

> 275. *Price Squeeze Concerns Are Adequately Addressed.* Several parties have argued that current access charge rate levels create the conditions for an

[43] These relationships are complicated by the fact that within their own regions the LECs receive revenues both as direct providers of long-distance services and in providing access to other IXCs. This has the consequence that any losses that they might suffer by reducing their retail rates, with anti-competitive intent, would be cushioned by additional sales of access services stemming from the increase in end-market demand stimulated by those price reductions and would therefore not have to be recovered entirely by retail price increases after competitors had been driven out. There are at least two counter-considerations. First, to the extent this dual relationship of the LECs to this market gives them an additional incentive to reduce prices to ultimate customers, that is in itself not necessarily a bad thing, to put it mildly, particularly in a market that is inadequately competitive. In fact, Hinton, Zona, Schmalensee and Taylor have recently demonstrated that while under conditions of imperfect competition, such as do clearly prevail in the long-distance business, a less efficient ILEC might as a result take some business away from a more efficient IXC, the social costs of the consequent productive inefficiency—even in that remote eventuality—would be far outweighed by the social gains accruing to consumers in the form of reduced prices. (Paul J. Hinton, J. Douglas Zona, Richard L. Schmalensee and William E. Taylor, "An Analysis of the Welfare Effects of Long Distance Market Entry by an Integrated Access and Long Distance Provider," *Journal of Regulatory Economics*, Vol. 13, 1988, pp. 183-196.) Second, these additional access revenues would compensate or more than compensate for the retail price reductions only under special and improbable circumstances: the LEC would have to have a share of the interLATA market sufficiently *large* to depress the overall market price, if it were to try to put a squeeze on competitors, yet not so large that its consequent loss of revenues from its own retail sales would not be offset by the increase in its revenues from the sale of access to competitors. Moreover, any price reductions encouraged by the complicating consideration we have just described would pose a threat to competition only if the resulting relationship between the access and the retail charges of the BOCs violated the imputation requirements of the Act, as well as all the other safeguards in place at the state levels designed to prevent predatory pricing.

In his Supplemental Affidavit, Marius Schwartz likewise minimizes this unique incentive of the RBOCs to cut their interLATA prices, on the ground that they would in most circumstances lose more revenue directly from those reductions than they would gain from increased sale of access, as our own exposition suggests. We point out, however, that in this discussion he ignores the pressures on the RBOCs to offer discounts on the prices of the incumbent IXC's—as other ILECs have indeed done on entering this market—as a means of breaking into it, entirely apart from the incidental benefit to them of increased access revenues, to the extent these discounts expand the total market anticompetitive price squeeze when a LEC affiliate offers interexchange services in competition with IXCs....

278. We conclude that, although an incumbent LEC's control of exchange and exchange access facilities may give it the incentive and ability to engage in a price squeeze, we have in place adequate safeguards against such conduct....

279. The *Fifth Competitive Carrier Report and Order* separation requirements have been in place for over ten years, and independent (non-BOC) incumbent LECs have been providing in-region, interexchange services on a separated basis with no substantiated complaints of a price squeeze. Under these separation requirements, incumbent LECs are required to maintain separate books of account, permitting us to trace and document improper allocation of costs and/or assets between a LEC and its long-distance affiliate, as well as to detect discriminatory conduct. In addition, we prohibit joint ownership of facilities, which further reduces the risk of improper allocations of the costs of common facilities between the incumbent LEC and its interexchange affiliate. [T]he prohibition on jointly-owned facilities also helps to deter any discrimination in access to the LEC's transmission and switching facilities by requiring the affiliates to follow the same procedures as competing interexchange carriers to obtain access to those facilities. Finally, our requirement that incumbent LECs offer services at tariffed rates, or on the same basis as requesting carriers that have negotiated interconnection agreements pursuant to section 251 reduces the risk of a price squeeze to the extent that an affiliate's long-distance prices would have to exceed their costs for tariffed services.

281. Furthermore, even if a LEC were able to allocate improperly the costs of its affiliate's interexchange services, we conclude that it is unlikely that the LEC's interexchange affiliate could engage successfully in predation.[44]

48. Moreover, whereas the rules for entry by competitors into the local exchange market are still in the process of being hammered out, the arrangements for fair access by the long distance carriers to the facilities of the BOCs—dealing with problems of provisioning, repair, billing, segregation of proprietary information and the like by even-handed negotiations between the BOCs and interexchange carriers—have been in place *for upwards of a decade*. Those same unbiased interconnection arrangements would continue if the BOCs were permitted to carry interLATA traffic and, as we will point out presently, any deterioration would be all the

[44] First Report and Order, In the Matter of Access Charge Reform, CC Docket No. 96-262 et al., Adopted, May 7, 1997, pars. 275, 278, 279, 281 (footnotes omitted).

more visible because of the long-standing nature of the arrangements. Hence there can be little concern that the terms and conditions of interLATA interconnection could distort the competitive process henceforward.

2. The anti-discrimination requirements of the Telecommunications Act

49. Irrespective of whether they enter interLATA toll markets, the Telecommunications Act requires RBOCs to provide interconnection and access to unbundled elements on a non-discriminatory basis.[45] The language could not be clearer. Incumbent local exchange carriers have the duty to provide interconnection

> at any technically feasible point within the carrier's network; [and] that is at least equal in quality provided by the local exchange carrier to itself or any subsidiary, affiliate, or any other party to which the carrier provides interconnection. (Section 251 (c) (2) (B) and (C))

Further, ILECs have

> [t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and Section 252. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service. (Section 251 (c) (3)).

50. Further amplifying this nondiscrimination standard is the "checklist" contained in Section 271 spelling out the prerequisites for interLATA entry.

51. Notwithstanding this clear Congressional directive for non-discriminatory interconnection, we must confront the counter argument that the BOCs will have every incentive

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[45] The unbundled elements include, and under FCC rules can be combined to include, all components of currently-used carrier access services. Coupled with the resale requirements of the Act, these provisions encourage entry without requiring large amounts of investment, the implications of which we discuss more fully below.

to flout it, once they are permitted to offer interLATA service themselves, and all sorts of possible devious ways of doing so.

52. The access arrangements that have been in place for over twelve years, as we have already pointed out, were developed during a period in which the RBOCs had strong incentives to provide high quality service, undiluted by competitive (or anti-competitive) considerations. Moreover, those incentives have been intensified by the emergence of competitors for access traffic: every major metropolitan area in the country—embracing a large share of the BOCs' total business—is now served by at least one CAP. And, it is important to bear in mind, it is discrimination in the provision of *access*, not of other local exchange services, that opponents claim the RBOCs will practice, with adverse competitive consequences, if they are permitted to compete with the incumbent IXCs.

53. Explicit oversight by both regulators and purchasers of access provides strong additional guarantees of good service. Quality standards are often built into tariffs or other administrative rules, and they are regularly monitored and audited by IXCs and regulatory agencies alike. The FCC routinely monitors them through quarterly and semi-annual reports of measures such as installation and repair intervals, post-dial delay, transmission quality and service quality complaints. Finally, RBOCs have worked out monitoring and auditing programs directly with their IXC customers, programs that may include financial penalties for failure to meet quality standards.

54. Our conclusions about the sufficiency of these safeguards have had the explicit endorsement of the FCC. The Commission states in its recent order on non-accounting safeguards,

> We believe...that sufficient mechanisms already exist within the 1996 Act both to deter anticompetitive behavior and to facilitate the detection of potential violations of section 272 requirements
>
> We also find that, beyond the reporting requirements mandated under the 1996 Act, there are other avenues by which a telecommunications carrier may obtain information relevant to detecting anticompetitive BOC conduct. For example, competitive telecommunications carriers, on their own initiative, could seek to incorporate certain performance and quality standards into their negotiated or arbitrated interconnection agreements to ensure that BOCs satisfy their obligation to provide service in a nondiscriminatory manner

And, it concludes,

> We believe that the reporting requirements required by the 1996 Act, those required under state law, and those that may be incorporated into interconnection agreements negotiated in good faith between BOCs and competing carriers will collectively minimize the potential for anticompetitive conduct by the BOC in its interexchange operations.[46]

3. Incentive regulation

55. As of the end of 1996, at least 30 states and the FCC have substituted price caps for traditional cost-plus, rate base rate of return regulation. In June 1997, the "Oklahoma Telecommunications Act of 1997," which, in effect, establishes a rate case moratorium until 2001 for SWBT, became law. This rate freeze is a regime that confers many of the benefits of pure price regulation.[47] Price caps represent an improvement over the traditional methods of regulation in two ways. First, they supply stronger incentives on the part of the regulated firms to improve their efficiency, since they retain the benefits of any such cost reductions—subject of course to reexamination of the price cap formulas. Second, and more directly pertinent in the present context, they can eliminate the incentive of the regulated firms to engage in predation or

[46] First Report and Order and Further Notice of Proposed Rulemaking, In The Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of The Communications Act of 1934, as amended, FCC, CC Docket No. 96-149, Adopted: December 23, 1996, Released: December 24, 1996, pars. 321, 326 and 327.

[47] Testimony of Alfred E. Kahn, Kansas Corporation Commission Docket No. 190, 492-U, June 14, 1996.

otherwise cross-subsidize competitive services because, by breaking the link between the firms' overall profits and regulated rates, they eliminate—to the extent the price cap regimes are pure[48]—the opportunity to recover all of those costs or losses from monopoly customers. Unsurprisingly, state regulators and Federal courts have ruled that price cap regulation can be an effective safeguard against cross-subsidization and other such anticompetitive behavior.[49]

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[48] That is to say, to the extent that they do not provide for sharing between companies and ratepayers of excesses or inadequacies of profits and are not promptly "corrected" to eliminate excessive profits or losses, either retroactively or prospectively. The majority of the plans are indeed "pure" in the former sense: of the (at least) 29 states we counted as having adopted some form of price cap regulation as of June 1996, only two had provisions for sharing with ratepayers either surpluses or deficiencies in achieved rates of return. The same is true of the recently revised FCC formula. Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, In The Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform, Adopted: May 7, 1997, Released: May 21, 1997.

As for "purity" in the sense of a complete abandonment of tests of the price cap formulas or freezes against achieved rates of return, no plan to our knowledge rigidly excluded the possibility of such a test—in this sense, no plan was "pure." On the other hand, our survey, as of June 1996, of price cap plans adopted in the previous three years disclosed that the commissions were typically planning on an approximately five year interval before subjecting the formulas to review. The periods (in years) were: Illinois—3; Iowa—4; Kansas—5; Kentucky—at least 4; Maine—5; Massachusetts—at least 6; Michigan—2; New Jersey—6; North Carolina—5; Ohio—6; Pennsylvania—5; South Carolina—1; and Wisconsin—6.

[49] [A] well designed price cap plan insulates ratepayers from investment risk and subsidization of new ventures. Massachusetts Department of Public Utilities, *NYNEX Price Cap*, D.P.U. 94-50 (May 12, 1995), p. 121.

A properly designed alternative regulation plan affords the opportunity not only for the Company to transition itself to a more competitive environment, but allows this Commission to implement safeguards and allocate risk in a fashion that protects the interests of all interested parties. Illinois Commerce Commission, 92-0448/93-0239 Consol. (October 11, 1994), p. 19.

We find attractive many aspects of a pure price cap model for establishing revenue levels .... The utility and its shareholders would be completely at risk for their operational decisions, and incentives to cross-subsidize more competitive activities with monopoly profits from basic services would be greatly reduced. California Public Service Commission, Decision 89-10-031, In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers (October 12, 1989), at 172-173.

[T]he FCC has taken specific affirmative steps designed to deter and detect cross-subsidization by introducing price caps as well as further strengthening its cost accounting rules. We conclude that with the implementation of these measures, the FCC ... has demonstrated that the BOCs' incentive and ability to cross-subsidize will be significantly reduced. *California v. FCC*, No. 92-70083 and Consolidated Cases, 39 F.3d 919 (9th Cir. 1994) ("California III") at 926-927.

[Price cap regulation] reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling. *United States v. Western Elec. Co.*, 301 U.S. App. D.C. 268, 993 F.2d 1572 (D.C. Cir.), cert. Denied, 114 S. Ct. 487 (1993) at 1580.

4. Accounting safeguards

56. If there is one task at which regulators have proved themselves adept both before and since divestiture, it is in allocating costs in such a way as to protect purchasers of regulated—and, in particular, basic exchange—services and, by so doing, protecting competitors from cross-subsidization. Whether in so allocating costs as to set floors under the prices of competitive services markedly *above* incremental costs or in setting ceilings on basic service rates below incremental costs—and even farther below economically efficient levels—regulators have erred in the direction of *over*-protecting the BOCs' competitors from efficient competition and underpricing regulated services.[50]

57. In addition, the Commission has now officially found that its various accounting safeguards, including its existing rules governing transactions between the LECs and affiliates, are fully sufficient to guard against subsidization of competitive activities at the expense of subscribers to regulated telecommunications services.[51]

58. Inexplicably, the FCC's recent Ameritech Order contradicts its conclusions, only a few months earlier, about the efficacy of existing accounting and non-accounting safeguards in

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[50] Crandall and Waverman, *op.cit.*; A.E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics*, September 1984, pp. 1-2, 8-17 and "The Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation*, Vol. 1, No. 2, 1984, pp. 139-157; and D.L. Kaserman and J.W. Mayo, "Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation*, Vol. 11, No. 1, Winter 1994, pp. 119-147.

[51] Report and Order, In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, FCC 96-490, CC Docket No. 96-150, adopted: December 23, 1996, Released: December 24, 1996

> our cost allocation and affiliate transaction rules, in combination with audits, tariff review, and the complaint process, have proven successful at protecting regulated ratepayers from bearing the risks and costs of incumbent local exchange carriers' competitive ventures. (par. 25)

and:

> We have previously concluded that these [affiliate transaction] rules provide effective safeguards against cross-subsidization. (par. 108)

the long distance markets: "in order for this potential [benefit of RBOC entry] to become a reality, local telecommunications markets must first be open to competition so that a BOC cannot use its control over bottleneck local exchange facilities to undermine competition in the long distance market." (par. 388) We respectfully assert, and the evidence proffered in our statement demonstrates, that (1) RBOC entry will be beneficial independent of the development of local competition and (2) these benefits will not be diluted by any offsetting threat to the vitality of competition in the interLATA market, because, as the FCC recognized earlier, existing safeguards are adequate and it is simply inconceivable that the RBOCs could achieve monopoly power there at the expense of AT&T and the other incumbent carriers.[52]

B. The Unbundling, Resale and Interconnection Provisions of the 1996 Act and the Section 271 Checklist

59. Manifestly, the provisions of the Act and the FCC's Interconnection Order have had the intention, and will have the effect, of strengthening the competitive safeguards previously instituted:

- The Act and the FCC's Interconnection Order substantially expand and accentuate the degree of mandated non-discriminatory access to essential inputs. Not only are more unbundled elements to be provided at a greater number of points of interconnection, the prices charged for these elements must be approved under an open process and comply with explicit rules designed to afford rivals a fair opportunity to compete. If anything, these new terms and conditions are *too*

See also pars. 1 and 275.

[52] Professor Schwartz, the DOJ's economist, agrees with our conclusion (his original affidavit, par. 14). His primary concern, fully spelled out in his Supplemental Affidavit, is with the sufficiency of the RBOCs' incentives to cooperate in opening *local* markets to competition once they have received interLATA authority.

restrictive, to the detriment of efficient competitive initiatives and responses on the part of the incumbents.[53]

- The Telecommunications Act imposes restrictions and handicaps, for a limited number of years, on the offer by incumbent LECs of services they were previously barred from offering at all—such as in-region interLATA toll and manufacturing. These restrictions, in the form of required structural separations and limitations on the marketing of local exchange and other services, would limit their exploitation of economies of scope and thereby handicap them in competing with rivals, to which these restrictions would not apply

60. The incumbents' ability to offer in-region interLATA services is dependent on their satisfying a "checklist" of requirements, which include nondiscriminatory access to essential inputs and the demonstrated presence of competition for local exchange services.[54] These requirements, in and of themselves, hasten the erosion of the "local bottleneck"—the basis for the historical concern about anticompetitive behavior—and make lifting of the ban on interLATA services contingent on the FCC's being satisfied that the possibility of such behavior has been sufficiently minimized by the presence of local competition or its possibility.[55] In our opinion, which we will document below, the imposition of additional requirements, such as have

[53] A detailed critique of the Interconnection Order is unnecessary to this declaration. Our major concerns about it are that the prices and terms of access may be unduly favorable to entrants that choose to compete through resale of incumbents' services and use of unbundled elements. The adverse consequences of such an imbalance include: (1) diluting the incentives for facilities-based entry into local exchange services and (2) eroding the incumbents' incentives to upgrade their networks and offer innovative services.

[54] Alternatively, if no qualifying entrant pursues interconnection within the state, the BOC's demonstration that the necessary conditions for entry have been established will suffice (so-called "Track B" for interLATA entry).

[55] In fact, the "local bottleneck" is already eroding, independently of the Telecommunications Act, as indicated by the fact that revenues for competitive local exchange carriers grew by 80 percent in 1996 ("CLEC Revenues Grow 80% in 1996, Report Finds." *Telecommunications Reports*, February 5, 1997, p. 18)

more recently been recommended by the Department of Justice or are imposed or implied by the Commission's recent Ameritech Order, are neither necessary nor desirable.

61. Those who oppose BOC interLATA entry systematically ignore or minimize the extent to which the Act's interconnection arrangements, once in place, make those markets highly contestable— a market condition that Professor William J. Baumol, one of the major and original protagonists of contestability theory, recognizes "offers public interest benefits virtually the same as those insured by powerful competitive forces."[56]

62. The interconnection arrangements contemplated by the Act reduce the sunk investment costs of entry—which Professor Baumol identifies as the primary barrier to contestability[57]—dramatically. This is the consequence, in particular, of the resale obligations imposed on the ILECs. If, as the FCC and state commissions all over the country have decided or are in process of deciding, any would-be competitor has the right to purchase any and all of an ILEC's present retail services at its retail prices less a discount large enough to enable equally efficient retailers to compete with it, then *all* of the ILECs' present retail markets are as close to perfectly contestable as conceivable: rivals could at any time compete with them without having to sink a dollar into equipment that might not be fully retrievable if they decided to withdraw.

63. To be sure, that characterization may exaggerate the perfection of the consequent contestability of local telephone markets. Presumably the challenging reseller would have to put in place some sort of interfaces to purchase services from the ILEC, it would have to make marketing contacts with customers and arrangements for billing them, some of which costs

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[56] Affidavit of William J. Baumol on behalf of AT&T Corporation, AT&T Exhibit B, In the Matter of Application by SBC Communications Inc. for Authorization Under Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in the State of Oklahoma, CC Docket No. 97-121, page 14.

[57] *Id.*, p. 16.

would be irretrievable upon its withdrawal from the market. The notion of a competitive entrant having to be spared even the costs of contacting potential customers and billing them, however, would reduce the concept of contestability to an absurdity. Moreover, billing could always be purchased as needed and therefore involve no sunk cost. Competitors could contract out for marketing as well, under terms that, similarly, would make those costs avoidable. As the entry and continued existence of some five hundred resellers of long distance services attest, these barriers to entry and exit must be very low indeed. And the incremental costs to a carrier such as AT&T or MCI, already covering virtually the entire interLATA market, of adding such consumer contacts for purposes of selling intraLATA and local services as well—adding some lines to their advertisements and bills—must come as close to zero as can be conceived in the real world.

64. The requirements of the Act with respect to unbundled network elements are less likely to have such a dramatic effect *at the wholesale level*, at least initially. Certainly, if challengers are to have the ability to purchase from ILECs all the inputs necessary to duplicate the latter's offerings, without having to make any investments of their own, that is likely to make the supplying of those services at wholesale likewise highly contestable. On the other hand, presumably the challengers would have to make some financial commitment, if they chose to lease network elements from the incumbents. The ILECs might therefore continue, at least for a time, to enjoy monopoly power at the wholesale level.

65. The implications of this new situation are nevertheless dramatic. What it means, specifically, is that the typical requirements in governing statutes or regulations for reclassifying the entire range of *retail* local telephone services as competitive will, as a matter of economics, be *satisfied by these rules*. In these circumstances, deregulation of the *retail* operations of the

ILECs becomes not just possible but mandatory: effective competition demands that they have the identical freedom to compete at the retail level as is now enjoyed by their competitors, subject—with the major exception of the imputation or efficient component pricing rule (ECPR)[58]—to no obligations, handicaps or regulatory responsibilities that are not also borne by them.

66. As we have already suggested, the characterization of these markets as close to perfectly contestable applies most unqualifiedly to the *performance of the retailing function*, because of the sales for resale obligations of the incumbents. If a competitor seeking instead to produce the services itself by assembly of inputs from the ILECs would incur a greater volume of sunk costs, simple deregulation of the retail markets would expose consumers to possible exploitation, as the incumbent companies raised their retail prices to which the prescribed wholesale discounts would apply. The residual protection of consumers that these considerations suggest could be ensured, however, by a continuing obligation of the *wholesaling* ILEC to make its pre-existing retail services available at the regulated prices it charged at the time of transition less the prescribed discount—an obligation explicitly accepted by the Southern New England Telephone Company in reorganization proposals essentially approved recently by the Connecticut Department of Public Utility Control.[59]

67. The Justice Department, through an affidavit of May 14, 1997, filed on its behalf by Professor Marius Schwartz in response to Southwestern Bell's Oklahoma interLATA entry petition, recommended that RBOC entry into long-distance be delayed until local markets are

[58] The ECPR was first formulated by Professors Baumol and Willig. For a clear statement of it, see William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony*, Cambridge: The MIT Press, 1994.

[59] *DPUC Investigation of the Southern New England Telephone Company Affiliate Matters etc.*, Docket No. 94-10-05, *Decision*, June 25, 1997.

irreversibly open to competition (par 19)—that is, until new access arrangements have been clearly demonstrated to be working (par 182) Professor Schwartz also discusses how one would determine whether the local exchange had been irreversibly opened to competition. His preferred metric is the presence of competition (par 20).

68. The Justice Department's proposals would impose a substantial burden on the ILECs beyond the requirements of the Telecommunications Act. The Act requires only (1) the existence of one or more qualifying interconnection agreements with predominantly facilities-based carriers ("Track A") or (2) the establishment of approved interconnection terms and conditions in the absence of an interconnection request within a specified time period ("Track B"). The Justice Department would add a demonstration that competition has either started or been proven infeasible. But not only does it offer no proof that any additional requirements are necessary; it fails to recognize that they may be positively harmful.[60] Just as its proposal is intended to reinforce the incentives of the RBOCs to cooperate in facilitating the entry of competitors, it gives the opponents of RBOC entry into interLATA markets new opportunities to use the regulatory process to delay it.[61] We see no reason to alter the balance between these two incentives and opportunities established by the statute. Ascertaining whether entry has been "irreversibly established" and sufficient to satisfy the proposed additional test would be extremely contentious. For example, the filings of economists representing the IXCs in the Oklahoma case (and, to our knowledge, in Connecticut) make it clear that will argue that no

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[60] Similarly, the FCC's Ameritech Order provides no demonstration that the unspecified number of additional "factors" (par. 391) would do more good than harm

[61] For a forceful argument, which accords with our own experience, that the major IXCs have been far more resistant than the CLECs to concluding interconnection agreements without recourse to arbitration and less aggressive in deploying their own facilities locally, see Peter W. Huber, "Local Exchange Competition Under the Telecom Act," Telcom Policy and Analysis Group, Washington, D.C., Nov. 4, 1997, pp. 36-40.

amount of entry via resale or even by purchase of unbundled elements would be sufficient, yet, paradoxically, the most telling criticism of the FCC's interconnection order is that by prescribing excessively favorable terms—terms advocated by these same IXCs—for entry via those two routes, it discourages the genuinely independent, facilities-based, entry that they insist (in other contexts) is necessary. (In these circumstances, Professor Schwartz's assertion that "the most reliable demonstration of such opening [of local markets to competition] is ... meaningful local entry of *all three modes*" (Supplemental Affidavit, par. 5, stress supplied) has an unmistakable Catch 22 flavor.) The delays resulting from disputes of this kind would prevent consumers from enjoying the benefit of RBOC entry that Professor Schwartz acknowledges. In addition, the enhanced prospect of impeding RBOC entry by regulatory pleadings would provide intensified incentives for the IXCs to pursue less vigorous local entry strategies themselves than they otherwise would, because more vigorous local competition on their part would hasten the day of the RBOC entry into competition with them that they obviously are exerting strenuous efforts to obstruct.

69. Conversely, and for the same reasons, actual entry by RBOCs into long distance service would be likely to strengthen the IXCs' incentives to compete vigorously in the local market, since it would withdraw the reward for delay. As artificial and asymmetrical restrictions are removed for everyone, performance in the marketplace, rather than success or failure in gaming the regulatory process, will and should determine which companies succeed or fail.

70. Professor Schwartz mentions, but evidently fails to weigh in the balance, another aspect of the symmetry envisioned by the Telecommunication Act that argues on the side of removing the interLATA restriction on the RBOCs as quickly as possible. Under the Act, the extension of presubscription for intraLATA service is made contingent on and simultaneous with

permitting the BOCs to compete interLATA Against the incremental impetus that delay in lifting the latter restriction might give to the BOCs to encourage the development of local competition must logically be weighed the cost to consumers of the consequent delay in universalization of intraLATA presubscription. Since basic local rates to most subscribers are already repressed below efficient levels, whereas intraLATA toll rates remain egregiously inflated in order to generate a contribution toward holding down the former, it seems clear that the direct benefits of the introduction of presubscription to competitive IXCs for the latter services offers a far greater potential for consumer benefit than such incremental encouragement to competition in the provision of local services as retaining the ban would impart. This consideration is even more compelling in view of the fact that the resale provisions of the Act already offer CLECs a ready opportunity, by purchasing the subsidized services from the incumbent LECs, to bring the benefits of competition to the provision of such overpriced local services as Custom Calling features.

71. Professor Schwartz claims that his proposed standard would promote the public interest, because he believes that the benefits from the faster development of local competition that would be achieved by withholding interLATA authority from the RBOCs until they had satisfied the more stringent conditions he recommends would outweigh the costs of delaying RBOC interLATA entry. He bases this assessment, in his Supplemental Affidavit, on essentially qualitative considerations that are, in our opinion, biased against RBOC entry:

- The first, to which we have already responded (par. 42, above), is that the local market is both larger and has more room for improved performance, because it is "largely a regulated monopoly rife with distortions." (par. 18) As we have already pointed out, the distortions—whose dimensions and egregiousness we concede—are